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**MINUTES OF
MONETARY POLICY
COMMITTEE MEETING
9 AND 10 JANUARY 2008**

These are the minutes of the Monetary Policy Committee meeting held on 9 & 10 January 2008.

They are also available on the Internet

<http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2008/mpc0801.pdf>

The Bank of England Act 1998 gives the Bank of England operational responsibility for setting interest rates to meet the Government's inflation target. Operational decisions are taken by the Bank's Monetary Policy Committee. The Committee meets on a regular monthly basis and minutes of its meetings are released on the Wednesday of the second week after the meeting takes place. Accordingly, the minutes of the Committee meeting held on 6 and 7 February will be published on 20 February 2008.



MINUTES OF THE MONETARY POLICY COMMITTEE MEETING HELD ON 9-10 JANUARY 2008

1 Before turning to its immediate policy decision, the Committee discussed financial markets developments; the international economy; money, credit, demand and output; and supply, costs and prices.

Financial markets

2 There had been a marked reduction in the past month in the premia over expected policy rates in the term interbank markets, particularly for sterling. They were now back around their October levels, although still above those prior to the onset of financial turbulence in August. The co-ordinated actions by central banks in December to promote market liquidity around the turn of the year appeared to have helped, and the year-end had passed without the emergence of major new liquidity problems.

3 Forward spreads suggested that it might take several months before conditions in money markets returned to normal. There had been a marked widening of credit spreads and increases in credit default swap premia for financial institutions internationally since October and further announcements of mark-downs on assets were expected. That reflected continuing uncertainties about the extent and distribution of banks' losses on mortgage-backed securities and other balance-sheet items as a result of the US sub-prime crisis. US mortgage defaults had increased further. The total net losses from mortgage defaults so far had not been large relative to the capital of banks, but the complexity and opacity of many of the financial instruments ultimately backed by mortgage assets meant that some institutions might still be facing unexpectedly large exposures.

4 Experience from previous banking crises suggested that the faster bad debts were acknowledged and banking systems recapitalised, the sooner the tightening of credit conditions would be unwound. It was, therefore, good news that several sponsors of structured investment vehicles had succeeded in restructuring them and that a number of banks had responded quickly by raising fresh capital in bilateral deals with, among others, sovereign wealth funds. Nevertheless, uncertainty would remain high at least until after the next financial reporting season and, with the prospect of defaults rising in a slowing economy, banks were becoming more cautious about expanding their balance sheets.

In Europe, and especially the United Kingdom, the introduction of the new Basel II regulatory regime for all banks at the beginning of 2008 would also affect their risk-weighted capital ratios. That might have a knock-on effect on their willingness to lend.

5 Since the Committee's previous meeting, market expectations of the near-term path of official rates had fallen by 15 to 25 basis points for the United Kingdom and by 25 to 50 basis points for the United States. In contrast, expectations of the policy rate for the euro area had risen by 5 to 10 basis points. Market participants attached a high probability to a reduction in Bank Rate this month or next, followed by further cuts over the course of the year. Respondents to the Reuters survey assessed the probability of a reduction in Bank Rate this month at around 40%, although only around a fifth of respondents had a reduction as their central expectation. Market commentary had focused largely on UK demand developments rather than the inflation outlook. In the United States, the Federal Open Market Committee (FOMC) had reduced its target for the federal funds rate last month. Markets had priced in another fall of at least 50 basis points this month, with more to follow. The expected path of the euro-area policy rate remained broadly flat.

6 Movements in longer-term forward interest rates around the world had been small. UK inflation forward rates implied by the index-linked gilts market had fallen at the short end of the curve but had increased at the long end. However, surveys suggested that long-term inflation expectations had remained broadly stable.

7 Since the Committee's previous meeting, the range of falls of equity price indices in the United Kingdom, the rest of Europe and the United States was 3 to 5%. Uncertainty about future equity prices, as measured by implied volatility, had picked up, but remained low by the standards of past episodes of financial stress. Equity risk premia appeared to have risen. Investment analysts' forecasts suggested that corporate earnings per share were expected to rise in 2008 in both the United States and the United Kingdom. However, these forecasts did not necessarily coincide with the expectations of equity holders themselves, given an expected slowdown in activity.

8 The sterling effective exchange rate index had fallen by around 4% on the month, bringing it around 6% below the starting level in the November *Inflation Report* projections. Most of the movement over December could be explained by movements in the sterling yield curve relative to other currencies, and thus could be regarded as a response to an adverse demand shock in the United Kingdom. However, movements in relative interest rates were less able to explain the fall over a

longer period. The recent revisions to National Accounts data, showing a larger estimated UK current account deficit, might have prompted a change in market perceptions of the long-run equilibrium real exchange rate, and could have made sterling more vulnerable to further depreciation. That was consistent with the increase in the downward skew of the distribution of market expectations for the value of sterling (as implied by financial derivative prices), which could only partly be explained by changes in the distribution of relative interest rate expectations.

The international economy

9 In the United States, the housing market had continued to deteriorate. However, it remained unclear to what extent the problems in the housing market were spilling over into other sectors of the economy. As far as indicators of output were concerned, the most recent Institute for Supply Management (ISM) balance for manufacturing had signalled contraction, but the non-manufacturing ISM measure had remained above the neutral 50 level. On the demand side, business spending appeared to be holding up, with increases in ‘core’ capital good shipments (non-defence, excluding aircraft) and non-residential construction expenditure in November. Consumption was estimated to have increased by 0.5% in November, despite falling house prices. Near-term prospects, however, were less encouraging, with a further fall in the Michigan survey measure of consumer confidence, a sharp fall in the number of construction jobs, a very small increase in total non-farm payrolls and a rise in the unemployment rate from 4.7% to 5%. A number of market commentators had suggested that the probability of a recession in the United States in 2008 had increased.

10 Headline consumer price inflation measures had risen sharply in the United States to annual rates around 4%, largely reflecting higher energy prices. The FOMC’s preferred measure of ‘core’ inflation (which excluded energy) had also edged up and annual producer price inflation had reached a 26-year high.

11 Quarterly GDP growth in the euro area had been 0.8% in Q3, according to the latest data release, but indicators for Q4 continued to suggest that growth had slowed, broadly in line with the November *Inflation Report* projections. Output growth in the euro area had been driven primarily by exports and investment over the past couple of years, so decelerating world demand and the appreciation of the euro would result in slower growth if there were not some rebalancing of demand, with consumption making a stronger contribution.

12 As in the United States, global cost pressures had been feeding through into domestic prices in the euro area. Consumer price inflation was 3.1% in both November and December.

13 There had also been some downside news about growth in Japan, with a downward revision to the estimate of Q3 GDP growth and a fall in business confidence as measured by the Tankan survey. For the rest of Asia and other emerging markets, the latest data for GDP in the third quarter had generally been robust.

14 Some of the most striking news had been about commodity prices. The dollar price of oil had risen by around 7% and the *Economist* index of food prices had increased by 5% on the month. The sterling oil price was around 15% higher than the starting level in the November *Inflation Report* projections. Energy prices were more likely than food prices to stay high in the medium term, as the supply response for foodstuffs was likely to be faster. The production and refining of crude oil were unlikely to pick up pace for some time and the substitution of alternative energy sources for oil was a costly and time-consuming process. Higher prices had been effective in reducing demand for oil in the OECD, but demand was continuing to grow rapidly in many emerging-market economies, in some cases supported by subsidies designed to insulate domestic economies from the increase in the world price.

Money, credit, demand and output

15 The most recent quarterly UK National Accounts data had left the estimate of Q3 GDP growth unrevised at 0.7%, although the growth rate of service sector output had been revised down a little. The estimate of domestic demand growth in Q3 had been revised up to 1.5%, the strongest rate since 1998, while the contribution of net trade had been revised down to -0.9 percentage points, its weakest since 1995. Consumption growth, at 1.1%, had been strong. That and the revised estimate of the growth of real post-tax labour income were more in line than the earlier vintages of these data had been. Business investment was also now estimated to have grown, by 2%, which was more in line than the previous estimate with what surveys had suggested.

16 The UK current account deficit was now estimated to have increased to 5.7% of GDP in Q3 – the biggest quarterly deficit in the past 50 years and proportionally the largest in the G7. There had been significant revisions to the estimates of net foreign investment income, affecting the UK corporate sector's financial balance rather than those of the household and public sectors. As the United

Kingdom had been running a persistent current account deficit, it was not surprising that foreigners had built up their net claims on UK residents, thus reducing UK net income from abroad. The revisions to the sectoral financial balances had two main implications. First, the long-run equilibrium value of the real sterling exchange rate might be lower than previously thought by market participants. Second, the UK corporate sector's financial position might not be as healthy as it had seemed, given that it had been running a lower financial surplus than previously thought.

17 Indicators for Q4 suggested that GDP growth had slowed broadly as expected at the time of the November *Inflation Report*. The CIPS/NTC business activity balance for services had risen marginally in December, but activity appeared subdued across most sectors.

18 Among the demand-side indicators for Q4, retail sales volumes had increased by 0.4% in November. Reports from the Bank's regional Agents and responses to the British Retail Consortium survey in December pointed to sluggish annual growth in the value of sales, coupled with a compression of retailers' margins to sustain volumes. That was unlikely to continue indefinitely, and some cut-back in retailers' orders and a recovery in margins seemed probable at some stage, implying a slowdown in real consumption growth when that happened. Such a slowdown would also be consistent with the tightening of credit conditions. The Bank's latest *Credit Conditions Survey* suggested that the availability of secured loans had been reduced in the fourth quarter, with a somewhat greater rise in mortgage spreads than respondents had expected in earlier surveys. The headline GfK measure of consumer confidence was at its lowest level since 1994, perhaps reflecting the outlook for real incomes and credit, although there had been much less of a fall in consumers' expectations of their own economic circumstances.

19 The housing market had weakened further, with house prices increasing a little less in Q4 than expected at the time of the November *Report*. The preview of the Royal Institution of Chartered Surveyors survey for December had suggested that the price balance had fallen to its lowest level since 1992, and the price expectations balance had dropped too. Mortgage approvals for house purchase had fallen again, to around 40% below their level a year earlier.

20 The Bank's *Credit Conditions Survey* also pointed to a sharp fall in the availability of credit to larger businesses and expectations that conditions would tighten further over the next three months. There had been a decline in the Bank's regional Agents' scores for investment intentions and a reduction in capital goods orders had been reported in the latest CIPS/NTC survey of manufacturing.

At the same time, commercial property prices had fallen sharply. So far, it was difficult to detect any spillovers from financial market conditions to activity in the corporate sector, apart from finance and commercial property. Nevertheless, against the background of weaker corporate balance sheets than previously thought, the outlook for business investment was perhaps poorer than it had been last month.

21 Broad money growth, having dropped sharply in October, weakened further in November. The three-month annualised growth rate had declined to under 7%. But distortions resulting from the financial market turmoil meant that it was still not clear how much of a risk to nominal demand growth that constituted.

Supply, costs and prices

22 Employment had risen by 0.4% in the three months to October and the employment rate had edged up. But more forward-looking indicators suggested some weakening in labour demand. The latest KPMG/REC *Report on Jobs* again reported weaker demand for staff and the latest Manpower survey showed employment intentions falling back to their lowest since 2001. Prospects had been worsening for financial and business services, distribution and construction, the very sectors that had accounted for most of the growth in employment in the year to 2007 Q3.

23 Annual earnings growth fell in October, according to both the average earnings index (AEI) and the experimental average weekly earnings (AWE) measure, with the decline particularly pronounced on the latter, though a wedge between the two measures remained. There had been little news about pay settlements.

24 Food and fuel prices had contributed to higher input and output price inflation. Manufacturers' input prices rose sharply, by 1.7%, in November, while manufacturers' output prices increased by 0.5%, taking the annual rate up to 4.5%, its highest since 1991. The CIPS/NTC manufacturing input and output price balances fell back in December but remained high. The CIPS/NTC service sector price balances rose a little.

25 CPI inflation had remained at 2.1% in November, although RPI inflation fell. The contribution from petrol prices rose to its highest level since 2000, but there were falls in the contributions from retail gas and electricity prices. In line with pre-release arrangements, an advance estimate of CPI inflation of 2.1% in December had been provided to the Governor ahead of publication.

26 The short-term outlook for retail gas and electricity prices had changed considerably over the past couple of months, given world energy price developments and the likely response of energy retailers. Food prices, too, were likely to push CPI inflation upwards and some of the recent depreciation of sterling would probably be reflected in import prices in the near term. There were considerable uncertainties around the short-term outlook. The paths of wholesale oil and gas prices were difficult to forecast, as were the pricing strategies of energy retailers. Although food and petrol prices and airfares were likely to rise faster, they were particularly volatile components of the CPI. And the extent and timing of the pass-through from the exchange rate depreciation were not easy to judge. Nevertheless, it now appeared likely that CPI inflation would rise quite sharply early in 2008 and RPI inflation seemed less likely to fall back in the short run than had previously been expected. Inflation expectations reported in the YouGov/Citigroup survey remained elevated but had changed little on the month.

The immediate policy decision

27 There had been a considerable amount of news over the past month that was relevant to the outlook for demand and inflation. At the time of the November *Inflation Report*, the Committee judged the risks to growth to lie on the downside and the risks to inflation to be balanced. Since then, the data outturns had been broadly in line with the November *Inflation Report* projections for output and activity, but the downside risks to future demand had increased, reflecting the outlook for UK-weighted global demand and credit conditions. However, the upside risks to inflation from supply-side developments had increased in each of the past two months, largely reflecting changes in food and energy prices and the exchange rate.

28 On the international front, recent indicators of growth had been broadly in line with the Committee's November *Inflation Report* projections, but the near-term outlook for UK-weighted world demand had deteriorated somewhat, as reflected in downward revisions to Consensus forecasts. Equity prices had fallen. It was still not clear to what extent the difficulties in the US housing market would spill over into the rest of the US economy and into the rest of the world. For the euro area, the

question was whether consumption growth would pick up any slack resulting from the impact of slowing US demand and the appreciation of the euro on net trade.

29 In the United Kingdom, the growth of domestic demand was estimated to have been very strong in 2007 Q3. But the CIPS/NTC surveys, reports from the Bank's regional Agents and other indicators suggested that the economy was slowing. Housing markets had weakened further. The Agents' recent survey of retail trade indicated that sales growth during the Christmas period had been lower than in the previous year, but it would be some time before the picture for December and January together would be clear.

30 Although output had been slowing broadly as expected, there remained a significant downside risk to UK activity, and hence to inflation in the medium term, from deteriorating credit conditions here and abroad. There could be a much sharper fall in growth than in the central projection in the November *Inflation Report*. While liquidity concerns in the money markets were gradually easing and financial markets had not been disrupted by turn-of-the-year liquidity problems as some had feared, concerns about credit risk remained. Banks were seeking to repair balance sheets and restore capital. That would have an effect outside the financial sector to the extent that it led banks to rein in their new lending, which the Bank's most recent credit conditions survey suggested was happening in the United Kingdom. There was a risk that such tightening would lead to a significant slowing in domestic demand growth.

31 There were upside risks to inflation, however, from the supply side. There had been further significant increases in world oil and food prices and it now seemed likely that retail gas and electricity prices would rise sooner and by more than previously expected. By themselves, these price increases could put substantial upward pressure on consumer price inflation in the short run, so that, for any given path of output, inflation was likely to be higher in the near term. On top of that, these shocks were compounded by a sharp decline in the sterling effective exchange rate index. Financial market prices suggested that there was a significant risk of further falls in sterling. If that were to crystallise, further pressure would be put on retail prices via higher import prices, the extent depending on the speed and degree of pass-through. Higher inflation in the short run could raise wage and price setters' inflation expectations, posing an upside risk to inflation over the medium term.

32 For most members, no change in Bank Rate was necessary this month. The short-run inflation outlook had worsened markedly. A second period during which inflation was significantly above target, so soon after the one in Spring 2007, might be more likely to lead people to revise up their expectations of future inflation, particularly if the rise in inflation persisted for longer. Movements in the yield curve and the depreciation of sterling had already provided some further monetary easing. Reductions in Bank Rate in two successive months might, given the current conjuncture, encourage observers to think that the Committee was focused more on stabilising demand than meeting the inflation target and so shift the yield curve down further. The Committee would be able to use the February forecast round to assess the medium-term outlook for inflation, and the impact on that of both the upside risk to inflation in the short term and the downside risk to demand and activity.

33 While also recognising the importance of the February forecast round, one member judged that the outlook for UK-weighted global demand had materially worsened, especially in the United States. Consequently, the risk of a sharp and persistent slowdown in activity had also increased. There was little likelihood that wage bargainers would seek higher awards if CPI inflation increased temporarily, judging by the recent behaviour of pay. In that member's view, a further cut was warranted and would be consistent with financial market expectations.

34 The Governor invited the Committee to vote on the proposition that Bank Rate should be maintained at 5.5%. Eight members of the Committee (the Governor, Rachel Lomax, John Gieve, Kate Barker, Charles Bean, Tim Besley, Andrew Sentance and Paul Tucker) voted in favour of the proposition. David Blanchflower voted against, preferring a reduction in Bank Rate of 25 basis points.

35 The following members of the Committee were present:

Mervyn King, Governor
Rachel Lomax, Deputy Governor responsible for monetary policy
John Gieve, Deputy Governor responsible for financial stability
Kate Barker
Charles Bean
Tim Besley
David Blanchflower
Andrew Sentance
Paul Tucker

Dave Ramsden was present as the Treasury representative.